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NSC FOR KURT TONG

E.O. 12958: N/A
TAGS: EFIN EINV PREL CH
SUBJECT: STOCK MARKET TOO HOT, SO CHINA RAISES TAXES

REF: SHANGHAI 174 and previous

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¶1. (SBU) Summary: The Ministry of Finance (MOF) announced on May 29 that the stamp tax charged on every stock trade would rise from .1 percent to .3 percent of the total value of that trade, effective May 30. Consulate contacts and industry analysts said this was a further attempt to cool down China's overheated equities market, but would have little long-term effect. This increase in taxes on trades came about ten days after every brokerage in China, apparently in concert, raised its commission rates from an average of 12 basis points to 23 basis points. The government's hope in increasing the stamp tax was to reduce the volatility and instability caused by speculative investors who held stocks only for short periods and had been "stir frying" their portfolios. At least in the short-term, government revenues were set to boom, with USD 108 million of stamp tax generated on May 30 on the Shanghai Stock Exchange (SSE) alone, compared to the mere USD 36 million that would have been generated on the same trading volume under the prior rates. The market closed down 6.5 percent on May 30, having set a new trade volume record with more than USD 35 billion worth of stocks changing hands. End summary.

¶2. (SBU) MOF announced May 29 that it would increase its stamp tax on securities trading from .1 percent to .3 percent of the value of each trade, effective May 30. (Note: MOF had denied rumors on May 23 that it was considering such an increase. End note.) Official press reports stated that this tax rise had been approved by the State Council and was "intended to help promote the healthy development of the securities markets." This move came on the heels of the May 18 increases in bank reserve requirements and interest rates. These policy steps were all aimed at trying to cool down the overheated equities market (Ref A), according to industry analysts and Consulate contacts.

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"The State Council Wants to Cool Down the Market"
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¶3. (SBU) SSE Deputy Director Chao Kejian told Econoff on May 30 that the SSE Composite Index had risen by more than 60 percent this year, on top of its 130 percent rise last year. Raising and lowering the stamp taxes on trades was something that MOF had done at least six times since stock trading began in 1990, he said. Raising and lowering the costs of trading had been used to either encourage or discourage trading, he added. This rise was because "the State Council wants to cool down the market." At .1 percent, China's taxes on equity trades were already among the world's most expensive, he said; raising them to .3 percent was "not reasonable."

¶4. (SBU) Like the recent increase in interest rates, Chao said he did not think that the increasing the stamp tax would have its desired effect. "It might work for three to four days, maybe a week," he said. But in the long term this step would "not be effective."

Stop the Stir-Frying

¶5. (SBU) Z-Ben Advisors Principal Peter Alexander's forecast for the effectiveness of this most recent cooling measure was the same as SSE's Chao. In a separate meeting on May 30, Alexander told Econoff that increasing the stamp duty from .1 percent to .3 percent per value of a trade "should have a limited impact on market sentiment." This would, however, be "great for the government's bottom line, in that revenue will be exponentially higher." Alexander noted that based upon a conservative daily trade volume of RMB 200 billion per day (USD 26 billion/day),

tax receipts will go from RMB 200 million (USD 26 million) to RMB 600 million (USD 78 million) per day. (Note: SSE's Chao had earlier told Econoff that this measure would increase the government's tax revenue by RMB 60-80 billion (USD 8-10 billion) this year. End note.)

¶6. (SBU) Pointing to steps that the central government had made in previous years to slow down the housing market as a model for what it is doing now, Alexander said that the government was "attempting to reduce activity without reducing the market's level." What the government was most concerned about, he said, was the uncertainty and instability in the market caused by short-term speculative trading. This was referred to as "stir-frying stocks" (chao gu) in Chinese, he said.

Brokerages Will Feel the Pain

¶7. (SBU) Shenyin & Wanguo Securities Company Deputy Director Li Qinghai told Econ Assistant on May 30 that although the stamp tax raise was aimed at curbing short-term speculative trading in the equity market, it would, in the long run, hurt securities firms since the higher stamp tax would decrease trade volume. Since securities brokers charged very low fees, their incomes were dependent on high trade volumes. Nonetheless, Li's view was that the overall bull market conditions had not changed.

¶8. (SBU) SinoPac Securities Investment Manager Rafe Xu separately told Econ Assistant on May 30 that this tax hike, when combined with the increased brokerage commission costs, greatly increased an individual investor's transaction costs. (Note: According to Z-Ben Advisor's Alexander, about ten days ago, every security house simultaneously had raised its commissions from an average of 12 basis points to 23 basis points. While there had been no public announcement that the brokerages were acting on government instruction, "You do the math!" said Alexander. End note.) These increased transaction costs would have a "strong negative impact on the market," said

Xu. He also speculated that the numbers of new investors opening trading accounts would decline as well.

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Market Responds with Record Volume; Trades Down
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¶9. (U) According to market information, investors in stocks listed on SSE responded to the increased tax on stock trades on the morning of May 30 by conducting a record number of trades. Total value of shares traded in the morning session (from 9:30 AM until 11:30 AM) was RMB 181 billion (USD 24 billion); the market traded lower by 6 percent. The previous record volume for a whole day's trading was 261 billion, set on May 24. (Note: At 0.3 percent per trade value, the Chinese government collected USD 72 million in tax revenue from the morning session alone. End note.) For the day, the market closed down 6.5 percent with 730 companies trading lower and only 43 companies trading higher. Total volume on May 30, both afternoon and morning trading sessions, was RMB 272 billion (USD 36 billion), a new record.
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